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Ashmore

An illustration of Soros-style Reflexivity

By Jan Dehn

Under which circumstances can global financial instability engender genuine economic hardship in EM countries? Argentina's recent woes provide an excellent illustration of so-called Soros-style reflexivity. Fortunately, not many other EM countries share Argentina's structural weaknesses, which include low inflation-fighting credibility and a poorly developed and largely dysfunctional domestic institutional investor base.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	-1.83%
MSCI EM Small Cap	9.7	–	-1.23%
MSCI Frontier	8.8	–	2.13%
MSCI Asia	12.1	–	-1.90%
Shanghai Composite	10.1	–	-9.21%
Hong Kong Hang Seng	7.9	–	-2.41%
MSCI EMEA	8.8	–	-1.40%
MSCI Latam	11.1	–	-1.85%
GBI-EM-GD	6.24%	–	-0.37%
ELMI+	5.82%	–	-0.12%
EM FX spot	–	–	-0.29%
EMBI GD	5.98%	347 bps	0.40%
EMBI GD IG	4.28%	173 bps	0.22%
EMBI GD HY	7.89%	540 bps	0.58%
CEMBI BD	5.63%	320 bps	0.28%
CEMBI BD IG	4.37%	195 bps	0.22%
CEMBI BD Non-IG	7.36%	493 bps	0.36%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	-0.33%
1-3yr UST	2.30%	–	0.03%
3-5yr UST	2.28%	–	0.10%
7-10yr UST	2.49%	–	0.30%
10yr+ UST	2.90%	–	1.02%
10yr+ Germany	0.01%	–	-0.61%
10yr+ Japan	-0.05%	–	0.02%
US HY	6.15%	359 bps	-0.02%
European HY	4.02%	439 bps	-0.29%
Barclays Ag	1.81%	-68 bps	0.32%
VIX Index*	15.44	–	2.33%
DXY Index*	97.41	–	-0.07%
EURUSD	1.1210	–	-0.05%
USDJPY	110.76	–	-0.59%
CRY Index*	180.68	–	-3.50%
Brent	71.1	–	-2.34%
Gold spot	1283	–	-0.07%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

An illustration of Soros-style reflexivity: The legendary Hungarian-born investor George Soros coined the term 'reflexivity' to describe a mechanism, whereby events originating entirely from within financial markets can have serious negative ramifications for the real economy in Emerging Markets (EM) countries. Reflexivity was a novel concept, because up to that point most investors had believed that crises originated within the real economy and then spread to financial markets. Soros pointed out that the direction of causality was often the other way around. Under which circumstances is Soros-style reflexivity a threat to EM countries?

The recent panic in credit and currency markets in Argentina offer an excellent illustration of Soros Reflexivity, because the events originated within banks in New York, yet may end up having serious economic and political implications in Argentina thousands of kilometres away unless the correct diagnosis and remedy are put in place.

So, what happened? Argentina recently repaid the sizeable 2019 Dollar-denominated sovereign government bond. Bond redemptions are an entirely normal thing in the USD 1.2trn EM sovereign bond market. Around large bond repayments, banks often take long positions in the next bond to mature on speculation that bondholders will maintain their overall exposure. In this case, they went long the large 2021 bond on the view that bond holders would re-invest the proceeds from the maturing 2019 bond into the 2021 bond. Had this happened, of course, it would have resulted in demand for the 2021 bond, higher prices and a handsome payday for the banks.

However, for various reasons most bondholders opted not to re-invest the proceeds from the 2019 bond into the 2021s. Moreover, polls ahead of the presidential election scheduled for Q3 2019 showed gains for former President Cristina Kirchner, which made existing bondholders nervous. The result was that the price of the 2021 bond actually began to fall, leaving the banks long and wrong. No longer able to take big hits to their much-reduced balance sheets due to the regulatory changes introduced in the aftermath of the Subprime Crisis, the investment banks has no choice but to scramble to hedge their losing bond positions in the Credit Default Swap (CDS) market.

The sudden demand for protection quickly pushed up the spread in the illiquid Argentinian CDS market from 950bps to 1300bps. The Argentinian peso took notice immediately, plunging from 41 pesos to the Dollar to 46 pesos to the Dollar.

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Emerging Markets

In most EM countries, bouts of CDS spread widening and currency weakness do not leave much of a mark on fundamentals. However, Argentina, and Turkey for that matter, is different from most other established EM countries in two important respects.

First, the government and private sector borrowers depend critically on access to external funding, since Argentina does not have a well-functioning domestic bond market. Second, domestic economic agents largely base their expectations of future inflation on the behaviour of Argentinian peso, because the central bank in Argentina has not managed to establish monetary policy credibility in a hundred years of trying.

Borrowing costs and inflation expectations are, of course, both important economic fundamentals. Unless funding costs quickly return to normal, Argentina's government (and private companies) will soon have to pay more to borrow. Unless inflation expectations decline soon, the central bank will be forced to raise rates, which will weaken the economy and undermine the current IMF program. In other words, a chain of events, which began with a dislocation in the market for Argentinian sovereign bonds in New York due to some bad trading decisions on the part of banks is morphing into a threat to the economic fundamentals in Argentina. This is classic Soros Reflexivity.

What can countries, such as Argentina, do in the face of Soros-style reflexivity? The correct policy response follows three steps: diagnosis, remedy and reform.

The correct diagnosis of the problem is absolutely critical. In this case, the problem originated in the credit markets far away from Argentina. There is nothing wrong with the current IMF program. Hence, it would be wrong to, say, make major changes to the economic program. The remedy should address the source of the problem, namely the dislocation in the bond market. In this case, the government should therefore trust in the integrity of the economic program, while seeking to turn the dislocation in the bond market to its advantage. It could do so, for example, by buying back its own bonds. A buyback operation would reduce upcoming maturities, stabilise market sentiment, relieve the imbalance on the balance sheet of the banks and generate considerable fiscal savings, since the bonds currently trade far below par (e.g. the 2021 bond is trading around 85c).

In fact, last week the government was able to achieve a notable stabilisation of local law Dollar bonds, when ANSES, the defective local government pension fund, was able to buy back a very small number of securities. This means that a larger program of sovereign bond buybacks in Argentina's external debt market would likely be highly effective, removing the need for banks to hedge their bad bets, settling the CDS market and thereby also stabilising the peso. Granted, a measure of currency stability can also be achieved with direct intervention in the FX market, which the government undertook last week, but the risk is that FX interventions alone will not be effective unless the underlying problem in the credit market is addressed. FX intervention in isolation could be a waste of money.

Finally, it is clear that Argentina's structural characteristics render it vulnerable to Soros-style reflexivity. Reform is required. Argentina needs to get to first base as far as monetary policy credibility is concerned. Also, Argentina needs to find a way to rebuild its domestic institutional savings base. The reason why countries such as Argentina and Turkey repeatedly find themselves in cross-hairs of speculators is precisely that they fail on basic macroeconomic policies and are unable to fund themselves in their home markets. By contrast, most other established EM countries have low inflation and obtain some 90% of their funding in their local markets. This means that they are not fundamentally vulnerable, even when external markets convulse.

- Turkey: The instability in Turkish markets looks set to continue at least until late June after the Supreme Election Council (SEC) ruled in favour of a re-run of the local election in Istanbul. The original election saw opposition party CHP win by a narrow margin. The re-run will take place on 23 June. The mayoral certificate of CHP mayor Ekrem Imamoglu was cancelled by SEC. The opposition has denounced the decision as "plain dictatorship". President Recep Tayyip Erdogan was mayor of Istanbul before running the country in an increasingly authoritarian fashion. It now seems likely that markets will focus on politics in Turkey for some time, which is almost certainly going to guarantee volatility, in our view. In other news, the yoy rate of CPI inflation moderated to a still very high 19.7% in April (compared to 19.9% yoy in March).

- Venezuela: Opposition leaders Juan Guaido and Leopoldo Lopez last week appealed to members of the military and ordinary citizens of Venezuela to overturn the government of Nicholas Maduro. They failed to achieve their aim. However, their efforts should be seen as part of a longer-term strategy aimed at achieving regime change. Guaido appears to have recognised that the Trump Administration is unwilling to support him beyond sanctions, so Guiado's only way to unseat Maduro is to seek to drive a wedge between the generals, who keep him in office and the lower ranks of the army without whom the generals are powerless. The main challenge facing Guaido in pursuing this strategy is that it requires staying power, which has not been the strong suit of the opposition in Venezuela. Hence, for now, Maduro looks secure in his job. A return to stability in the near-term should enable the National Assembly to vote to approve the now overdue coupon payment of the PDVSA 2021 bond. The grace period for the payment extends to late May.

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Emerging Markets

- **Brazil:** The official timeline for passing the pension reform implies that parliament could vote on the bill as early as June, although delays are likely to push passage to Q3 2019, in our view. Industrial production declined 1.3% in the month of March, seasonally adjusted. The 12-month primary fiscal deficit narrowed to 1.44% of GDP in March from 1.54% of GDP in February. The rate of unemployment declined to 12.7% in March versus 12.9% expected.

- **Panama:** PRD candidate Laurentino 'Nito' Cortizo has been elected as Panama's next president after winning with 33.2% of votes cast. PRD is the largest party in parliament, but will need to enter a coalition to form a majority. 'Nito' ran on an anti-corruption platform.

- **Mexico:** The recent run of positive data surprises in Mexico continued last week. All three PMI indices went up: the Inegi PMI rose 0.4 points to 51.9, the Markit PMI increased to 50.1 from 49.8, and the IMEF PMI rose 0.8 to 52.0. Meanwhile the IMEF services PMI also rose 1.1 points to 52.4, while business confidence increased 0.1 to 53.0 in March. Only consumer confidence softened. Remittances were up 8.3% yoy in March, while Mexico racked up real GDP growth of 1.3% yoy in Q1 2019. Credit to companies also improved.

- **Index news:** JP Morgan has launched its annual index governance consultation exercise, which will result in a decision whether or not to include Chinese bonds in the GBI EM GD. Bloomberg's Aggregate Index already includes Chinese bonds, while FTSE has already launched a review for possible inclusion of Chinese bonds in the WGBI. FTSE's decision is due by September.

Snippets:

- **Argentina:** Tax revenues turned positive in April, rising 9% mom, which is well ahead of monthly inflation (4% mom). The real economy expanded 0.2% in the month of February, seasonally adjusted, but industrial production declined in March after two months of expansion.
- **Chile:** IMACEC, a monthly GDP proxy, was up 1.9% yoy in March in line with expectations. Retail sales increased at a yoy rate of 0.7% and manufacturing production was 1.3% yoy higher in March. The rate of unemployment fell to 6.9%.
- **China:** The PBOC lowered the reserve requirement ratio for banks to 8%. The measure should increase the capacity of banks to lend some RMB 280bn. The Caixin services PMI moved higher to 54.5 in April from 54.4 in March, but the official PMI was 50.1, which was marginally lower than expected (50.5).
- **Colombia:** April CPI inflation was 3.25% yoy compared to 3.21% yoy in March with core inflation at 2.95% yoy. The central bank's core inflation target is 3.00%. In public comments, IMF officials said that Colombia's economy is accelerating.
- **Czech Republic:** The Czech National Bank hiked the policy rate by 25bps to 2%.
- **Egypt:** Manufacturing PMI pushed back into expansion territory after recording 50.8 in April from 49.9 in March.
- **India:** Services PMI was 51 in April. This was a softening, which is probably attributable to the on-going general election. Manufacturing PMI also softened to 51.8 in April from 52.6 in March. Revenue collection from GST reached an all-time high in April.
- **Indonesia:** The real economy expanded at a healthy rate of 5.1% yoy in Q1 2019. Net exports made a significant positive contribution to growth.
- **Malaysia:** The trade surplus increased to USD 3.5bn in March on rising exports and slowing imports. Inflation was 2.8% yoy in April.
- **Pakistan:** IMF's Resident Representative in Egypt, Dr. Reza Baqir, has been appointed as the new governor of the central bank in Pakistan. Egypt's IMF program has helped to restore confidence in Egypt's domestic markets.
- **Peru:** April inflation was 2.59% yoy. The central bank's target range for inflation is 2% +/- 1%.
- **Philippines:** S&P Ratings increased Philippines's sovereign credit rating by one notch to BBB+ (investment grade). CPI inflation was 3.0% yoy in April, which was plonk in the middle of the central bank's target range (2%-4%). The market has expected inflation of 3.1% yoy.
- **Poland:** CPI inflation increased to 2.2% yoy in April from 1.7% yoy in March. Core inflation was 1.8% yoy.
- **Qatar:** The manufacturing PMI declined 1.2 points to 48.9 in April.
- **Saudi Arabia:** The PMI was steady at 56.8 in April.
- **South Africa:** South Africa's general election will be held tomorrow. Markets will focus on whether ANC under Ramaphosa's leadership can hold on to the 62% share of the vote obtained in the last election in 2014.
- **South Korea:** The manufacturing PMI rose 1.4 points to 50.2, which is consistent with economic expansion. Inflation was 0.6% yoy in April. Export growth improved at the margin. Industrial production was up 1.4% mom in March.

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Emerging Markets

- **Sri Lanka:** Tourist arrivals were 7.5% lower in April than in the same month of last year due to recent church and hotel bombings.
- **Taiwan:** The manufacturing PMI fell to 48.2 in April from 49.0 in March, but Q1 2019 real GDP growth rate was 1.72% yoy versus 1.40% yoy expected.
- **Thailand:** The government approved a small fiscal stimulus of 0.14% of GDP.
- **United Arab Emirates:** The PMI hit a high of 57.6 in April after recording a strong print of 55.7 in March.

Global backdrop

The extreme instability of US tax policy continues unabated, with near-term negative ramifications for sentiment in global markets. Over the weekend, President Donald Trump announced his intention to hike taxes on American consumers of Chinese goods even further, possibly as early as Friday of this week. Economists agree that taxing people for consuming imports from other countries is extremely bad economic policy, yet the Trump Administration continues to do so. US tax policy instability began in December 2017, when Congress passed major unfunded tax cuts for the wealthiest Americans and corporations. Congress' tax cut, which will eventually cost the US government 7% of GDP, was extremely poorly timed to coincide with full employment for the US economy, which is why it has only had a very small impact on growth. Congress's tax cut was followed within months by unilateral taxes payable by American businesses, which import steel and aluminium. Then taxes were raised on American importers of goods from China. Higher taxes on trade not only force American companies and consumers to pay significantly higher prices for imports, but also cut off an important avenue of outsourcing. The net effect has been to weaken consumption and eat into US company earnings, triggering a major stock market decline in late 2018 and a subsequent lower trajectory for US company earnings.

Last year, OECD produced estimates for the likely cost if Trump goes ahead with his full set of taxes on American consumers of Chinese goods.[1] OECD estimates that the taxes could wipe out 1% of US GDP, which is roughly equivalent to one third to one half of America's current annual real GDP growth. If the latest US trade taxes go ahead, the United States will end up with one of the highest average trade taxes in the world of 7.5%, according to economists at Deutsche Bank. High trade taxes are associated with weaker economic performance. By contrast, OECD estimates that the impact on China (which would end up selling fewer goods to America's now more heavily taxed consumers and businesses) would only be equivalent to roughly one fifth of China's annual rate of real GDP growth.

China has not yet indicated how it will respond if Trump goes ahead with his threat to impose yet more taxes on American importers, but top Chinese trade negotiator Liu He is due to attend trade talks in the US this week. Regardless of the outcome of this latest bout of US tax erraticism, it is clearly becoming more risky for other countries to rely on their economic ties with the United States, where policy interventions are now frequent, unpredictable and often irrational.

In other US news, former Vice-president Joe Biden has entered the race to be the Democratic candidate for the November 2020 presidential election. Biden is more centrist than most Democrat hopefuls, so he may appeal to moderate Republicans and centrist Democrats alike. With respect to foreign policy, US has deployed an aircraft carrier and air force bombers to the Persian Gulf in an escalation of tensions with Iran. The United States unilaterally pulled out of a landmark nuclear agreement with Iran despite the fact that Iran has complied with the terms of the agreement. Iran has responded to US aggression by threatening to curtail cooperation with the nuclear agreement, hoping this will encourage European nations to apply pressure on the Trump Administration.

As for US economic news, the April jobs report was good, meaning that 263,000 new jobs were added to the US labour force. This suggests that recession is not imminent, although other data released last week point to clear late cycle symptoms, including softer inventories, a weaker housing market, lower core PCE inflation, soft ISM services and trade. Productivity picked up to 2.4%, which is positive, but productivity still remains within the range, which has prevailed all the way back to 2007. Unit labour costs declined, which means that labour's share of nonfarm business in America has now fallen to 56.3%, near the all-time low.

Our base case is that the US economy is slowing gradually. This should provide a calming economic backdrop even if the US policy environment is anything but stable. Federal Reserve Chairman labelled the current low level of inflation as 'transitory', which undermined hopes in some quarters for rate cuts this year. In a positive development, Trump nominee for the Federal Reserve, Stephen Moore, withdrew his nomination after criticism of his inadequate qualifications and allegations that he underpaid his wife alimony for many years. Both Trump's nominees have now been rejected.

Eurozone data is improving marginally. Non-annualised Euro-area GDP was 0.4% qoq versus 0.3% qoq expected, equivalent to 1.5% qoq saar. Euro-area inflation jumped to 1.24% yoy in April from 0.77% in March, while PMI was revised up 0.1 points to 47.9, which in turn is 0.4 points higher than in March. German retail sales ran at a qoq saar of 6.6% in Q1 2019, but factory orders declined this morning.

[1] http://www.oecd.org/eco/outlook/General-assessment-of-the-macroeconomic-situation-november-2018-OECD-economic-outlook-chapter.pdf

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Global backdrop

In UK, local elections dealt serious blows to the two main political parties. The ruling Conservative Party and the opposition Labour Party both suffered severe losses as voters shifted towards pro-EU parties, including the Liberal Democrats and the Green Party. A Yougov poll showed that 61% of British voters now favour remaining in the EU. The Labour and Conservative parties still officially favour Brexit; something has to give.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.50%	0.59%	10.59%	-3.84%	12.71%	3.93%
MSCI EM Small Cap	-1.15%	-0.93%	6.77%	-11.47%	6.38%	1.53%
MSCI Frontier	1.51%	1.47%	8.48%	-8.20%	6.15%	-0.47%
MSCI Asia	-1.55%	0.33%	11.80%	-3.39%	13.86%	6.59%
Shanghai Composite	-5.58%	-5.94%	16.59%	-3.69%	2.10%	9.92%
Hong Kong Hang Seng	-2.67%	-1.26%	10.98%	-1.65%	14.40%	6.94%
MSCI EMEA	-1.01%	4.15%	9.98%	-1.49%	8.75%	-0.38%
MSCI Latam	-1.43%	-0.99%	6.87%	-1.80%	11.14%	-1.22%
GBI EM GD	-0.34%	-0.51%	2.40%	-3.58%	3.23%	-1.19%
ELMI+	-0.13%	-0.06%	1.42%	-1.58%	2.62%	-0.80%
EM FX Spot	-0.31%	-0.52%	-0.26%	-7.43%	-2.56%	-7.19%
EMBI GD	0.27%	0.51%	7.50%	7.55%	5.48%	5.16%
EMBI GD IG	0.11%	0.69%	6.70%	8.88%	4.45%	4.51%
EMBI GD HY	0.42%	0.35%	8.38%	6.21%	6.64%	5.68%
CEMBI BD	0.19%	0.97%	6.17%	6.91%	5.38%	4.81%
CEMBI BD IG	0.16%	0.88%	5.69%	7.68%	4.18%	4.24%
CEMBI BD Non-IG	0.23%	1.09%	6.80%	5.97%	7.33%	5.56%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-0.43%	3.60%	17.74%	12.30%	14.82%	11.70%
1-3yr UST	-0.03%	0.17%	1.17%	3.08%	0.99%	0.99%
3-5yr UST	-0.05%	0.04%	1.63%	4.53%	0.93%	1.66%
7-10yr UST	0.07%	-0.36%	2.50%	6.69%	0.67%	2.64%
10yr+ UST	0.54%	-1.26%	3.35%	7.22%	0.92%	4.46%
10yr+ Germany	-0.10%	-1.43%	3.91%	10.08%	2.55%	6.76%
10yr+ Japan	0.02%	-0.62%	2.66%	3.50%	-0.05%	4.61%
US HY	-0.05%	1.37%	8.73%	6.78%	8.01%	4.79%
European HY	-0.30%	1.06%	6.75%	2.50%	4.82%	4.16%
Barclays Ag	0.07%	-0.23%	1.97%	1.47%	0.93%	0.66%
VIX Index*	17.68%	12.62%	-39.26%	4.68%	4.89%	15.22%
DXY Index*	-0.07%	0.13%	1.29%	5.02%	3.75%	22.99%
CRY Index*	-1.94%	-1.67%	6.41%	-11.27%	0.43%	-41.15%
EURUSD	-0.05%	-0.06%	-2.26%	-5.97%	-1.71%	-19.41%
USDJPY	-0.59%	-0.08%	0.97%	1.53%	3.40%	8.69%
Brent	-2.34%	3.96%	32.16%	-6.66%	56.71%	-34.25%
Gold spot	-0.07%	-0.75%	0.01%	-2.40%	-0.41%	-0.57%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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